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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products	Docket No. RM2017-3

INITIAL COMMENTS OF NETFLIX
IN RESPONSE TO ORDER NO. 4258

(March 1, 2018)

Netflix, Inc. ("Netflix") submits these Initial Comments in response to Order No. 4258 in this docket. Netflix is the world's leading subscription service for movies and TV shows. Founded in 1997, Netflix has led change and has helped respond to subscribers' interests. As of December 31, 2016, Netflix had 93.8 million global streaming memberships, 49.4 million domestic streaming memberships, and 4.1 million domestic DVD memberships, with overlap in the latter two categories. A DVD member can order multiple DVDs, each of which is sent and returned by the mail, making Netflix one of the largest users of First-Class Mail.

I. SUMMARY

In Order No. 4257,[1] the Commission concluded that the CPI cap system had not achieved Objective 5 of the PAEA, "to assure adequate revenues … to maintain [the Postal Service's] financial stability."[2] In Order No. 4258, the Commission proposed a new five-year rate plan to generate an additional $2.7 billion of revenue per year, the amount it deemed necessary to put the Postal Service "on the path to medium-term financial stability."[3] Instead of imposing a one-time rate increase of 5.8% (plus CPI), which would provide the extra $2.7 billion immediately, the Commission proposed five years of annual increases of 2% (plus CPI). It also offered an extra 1% of rate authority for improved performance.[4]

Rather than debate the Commission's $2.7 billion revenue goal,[5] Netflix focuses these Initial Comments on the following three issues:

1. <u>Interim adjustments</u>: We urge the Commission to adopt a fair and flexible process to allow interim adjustments, including a scheduled mid-course review and a process for mailers to request a special review, similar to the Postal Service's exigency procedure. Due to inadequate data and looming uncertainties, including unknown elasticities, the threat of a death spiral, and

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1 Order No. 4257, PRC Docket No. RM2017-3, Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products (Dec. 1, 2017) (RM2017-3).

2 39 U.S.C. § 3622(b)(5).

3 Order No. 4258, RM2017-3, at 40.

4 The 1% Performance Incentive Mechanism (PIM) consists of 0.25% for maintaining service standards and 0.75% for increased operational efficiency as measured by the Total Factor Productivity (TFP). Order No. 4258 also specifies higher rate increases for "underwater" products and classes and establishes a band of acceptable pass-through percentages for workshare discounts.

5 *See* Order No. 4258 at 40. We use the term "revenue goal," as distinct from the technical term "revenue requirement," to refer to the $2.7 billion which the Commission seeks to recover from Market Dominant rate increases. The fact that we do not here address the appropriateness of this revenue goal should not be interpreted as agreement with its accuracy or application.

changing prefunding obligations, it will be extremely difficult, if not impossible, for the proposed rate plan to be effective over five years without interim adjustments.

2. Surcharges in Years 4 and 5: At the end of the five-year plan, the rate levels and resulting revenues for subsequent years will be much higher than the Commission has deemed necessary. To correct this, the Commission should convert the 2 - 3% add-on increases in Years 4 and 5 to temporary surcharges to be discontinued after Year 5.

3. The Performance Incentive Mechanism (PIM): The PIM conflicts with basic price cap principles and is unworkable. It should be removed from the plan.

II. THE COMMISSION SHOULD ESTABLISH A FAIR AND FLEXIBLE PROCESS FOR INTERIM ADJUSTMENTS.

In 2006, when Congress established the ten-year CPI cap regime, it could not foresee the Great Recession, eight-years of low inflation, explosive growth of high-speed internet and smart phones,[6] wide-spread consumer adoption of electronic bill presentment and payment methods, or remarkable growth of USPS Competitive Products. Today, at the cusp of adopting another cap regime, we can only imagine what changes will occur in the postal industry, economy, and technology in the next five years. If anything, the experience of the last ten years teaches us that, whatever plan is adopted today, it must include a process for interim adjustments. A flexible process is essential because the decisions the Commission makes today rest on (a) inadequate or conflicting data and (b) assumptions about a future that contains major uncertainties.

[6] The first iPhone was released in June 2007.

A. <u>In Light of Disputed Data and Looming Uncertainties, the Commission Should Adopt a Process for Making Adjustments over the Next Five Years.</u>

1. The Commission's Decision Will Unavoidably Rest on Inadequate or Disputed Data.

Approximately 2,100 pages of comments, declarations, studies, and charts were submitted in Phase I of this Review, and Phase II will probably see even more. Comments will undoubtedly present conflicting views on the amounts and timing of the Postal Service's financial need, the magnitude and term of the proposed rate increases, and mailers' likely response to the rate increases.[7] Many issues will continue to be unresolvable because of inadequate or unreliable measures and the lack of definitive research.[8] For example, the data on demand response to rate increases are inconclusive, and it is widely believed that the current elasticity estimates need improvement.[9] But mailers' responses to the proposed rate increases are critical factors – erroneous presumptions may hasten a death spiral.

To move forward, the Commission will have to base its decision on inadequate and often conflicting data. If projections are wrong – and some mistakes are inevitable – instituting a process now to make corrections in real time could reduce later harm to both the Postal Service and mailers. A process for interim adjustments will take some pressure off the need to arrive at a flawless plan from the outset. Congress recognized that the rate system adopted as a result of the ten-year review would need fine-tuning, and it authorized the Commission to conduct

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[7] For example, mailer groups have sought issuance of information requests on whether past capital investment decisions have been effective, claiming relevant to the stated goal of funding capital investment. *See* NPPC & NAPM Motion for Issuance of Information Requests, RM2017-3 (Jan. 19, 2018).

[8] *See*, *e.g.,* Declaration of Lyudmila Y. Bzhilyanskaya for the Public Representative, RM2017-3 (Mar. 20, 2017) and Declaration of John Kwoka, RM2017-3 (Mar. 20, 2017) (Kwoka). And even indisputable conclusions may be undercut by changed circumstances beyond the control of the Postal Service. *See* Section II.A.2, *infra*.

[9] *See* Petition to Improve Econometric Demand Equations for Market-Dominant Products and Related Estimates of Price Elasticities and Internet Diversion, PRC Docket No. RM2014-5 (May 2, 2014).

reviews "as appropriate."[10] It also provided the Commission general authority to "from time to time … by regulation revise … a modern system for regulating rates."[11]

Not only is it unlikely that the new rate system will work perfectly out of the gate, it is also unnecessary. Order No. 4257 found that the CPI cap system had achieved short-term stability but not medium- and long- term stability.[12] The goal of the new plan is to put the Postal Service on a "path to achieve medium-term stability,"[13] not to make it whole immediately, and the Commission has recognized that it may take time to achieve that stability. A process to make interim adjustments should be an integral part of such a multi-year plan.

2. The Industry Faces Major Uncertainties, and Unexpected Events Could Undercut Basic Assumptions.

Another reason the Commission cannot expect to arrive at a fixed solution is that uncertainties exist that are not within the control of either the Commission or the Postal Service. Conditions can and likely will change in the next five years, which may undercut assumptions underlying the new rate plan.

First, just as the Great Recession arrived in 2007 after passage of the PAEA, major changes in the overall economy may occur over the next five years. After years of slow recovery and low interest rates, the economy is starting to grow and inflation (and thus the CPI)

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10 39 U.S.C. § 3622(d)(3).

11 39 U.S.C. § 3622(a).

12 Order No. 4257 is currently on appeal to the D.C. Circuit Court of Appeals, Case No. 17-1276, and we do not take a position here on any of the findings in that order.

13 Order No. 4258 at 40.

is increasing. For example, last month's growth in the CPI was 0.545%, 3.5 times the average since 2006, suggesting an annual rate of 6.7%.[14]

Second, we find ourselves in a disrupted industry – delivery services continue to change rapidly with new entrants, such as Amazon, and new technology, such as delivery drones and driverless cars. E-commerce has exploded and continues to replace brick-and-mortar stores. Revenue from USPS Competitive Products has grown by 13.4 % in the last year, and continued growth is expected. Order No. 4258 assigns recovery of 100% of the revenue goal to Market Dominant products,[15] but growth of Competitive Product revenue could significantly reduce the amount needed.

Third, the threat of a death spiral is very real.[16] Harm from too high rate increases on Market Dominant products may be irreversible. When leaving the Postal Service, large mailers change their business models, which cannot then be easily reversed. For example, catalogers may push their customers to online alternatives to decrease mail volume, and banks may reward customers who convert to electronic statements. Once those customers have become used to electronic alternatives, returning to the mail will not occur, even if postage decreases. And if declines in volume result in further rate increases, as fixed costs are spread over reduced volume, the industry may be pushed into a death spiral. Moreover, by law, postage is not

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14 *See* USPS Attachment C, PRC Docket No. R2018-1 (Nov. 6, 2017), and more recent figures at https://data.bls.gov/pdq/SurveyOutputServlet;jsessionid=98AE915A4B9CE33CD85F5C86EB5532E9.tc_instance5.

15 *See* Initial Comments of Netflix, Inc., RM2017-3 (Mar. 20, 2017) (Phase I comments arguing that revenue from Market Dominants products should not carry the entire burden of the USPS' financial stability) (Netflix Phase I Comments), at 11-15. The Netflix Phase I Comments addressed other issues that are relevant to Order No. 4258, including legal limitations on the Commission's authority to change the rate system (at 9-11), the adequacy of revenues from Market Dominant products (at 15-18), and the lack of authority for the Commission to unilaterally adopt a rate system to recover defaulted Retiree Health Benefits amounts (at 19-24). *See also* n. 17, *infra*. Instead of repeating the discussion here, we incorporate the Netflix Phase I Comments by reference.

16 A "death spiral" results when rate increases result in lower volume as mailers leave the network. With less volume to cover fixed costs, rates then need to be increased even more, resulting in further drops in volume. This downward spiral, if not halted, threatens the survival of the firm. In addition, for the Postal Service, as volume decreases, scale economies may be lost but the obligation to deliver to every delivery point remains.

refundable, and, as proposed, the rate increases would be permanent, both factors in mailers' decision to leave the network entirely. If the current elasticity studies are inaccurate, as many believe, mailers may begin leaving the network at a very rapid rate. The Commission will need a mechanism to address this issue immediately rather than wait several years.

Fourth, substantial uncertainty surrounds the Postal Service's prefunding obligations. From 2010 to 2016, the Postal Service defaulted on a total of $34 billion of Retiree Health Benefit (RHB) obligations. That $34 billion is now a debt to OPM.[17] In September 2017, the Postal Service again defaulted on $6.9 billion of OPM obligations.[18] Congress could decide to impose an annual repayment schedule for the defaulted amounts, or it could forgive the debt. Or Congress could allow postal employees access to Medicare benefits, as proposed in pending H.R. 756,[19] which could significantly reduce the total unfunded liability.

In addition, the actual yearly assessments for prefunding and related obligations will have a significant effect on whether the $2.7 billion revenue goal remains appropriate. In 2017, OPM assessed the Postal Service for prefunding obligations for RHB, FERS, and CSRS ($3.6 billion), as well as the RHB normal costs ($3.3 billion). The Postal Service also had credit adjustments, mainly for Workers Compensation, in the amount of $2.2 billion.[20] The 2018

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17 *See* USPS Notice of Supplemental Information, RM2017-3 (Aug. 10, 2017). In the Netflix Phase I Comments, we argued that, by law, only Congress can resolve how the $34 billion of defaulted payments will be recovered. Netflix Phase I Comments at 19-22. OPM appears to have recognized this legal limitation in its 2017 re-amortization of the RHB obligations. It excluded the $34 billion from its calculation of the post-2016 annual RHB obligations. It set the $34 billion aside as "amounts past due" and did not designate any interest charges for it. Because the $34 billion was not included in the amortization of the remaining unfunded liability, the $1.0 billion annual RHB payment "only relates to the unfunded liability left over after subtracting the $33.9 [approximately $34] billion from the accrued actuarial liability." *Id*. at 2. Under the same legal reasoning, the PRC cannot unilaterally raise rates to recover the defaulted $34 billion. We do not interpret Order No. 4258 as attempting to do so.

18 *See Government Executive* (Sept. 29, 2017), at http://www.govexec.com/management/2017/09/usps-defaults-billions-mandatory-payments-despite-scheduled-relief/141404/.

19 H.R. 756 – 115th Congress: Postal Service Reform Act of 2017, at https://www.congress.gov/bill/115th-congress/house-bill/756.

20 USPS Fiscal Year 2018 Integrated Financial Plan (2018 IFP) at 3, at https://about.usps.com/who-we-are/financials/integrated-financial-plans/fy2018.pdf. *See also* USPS Notice of Supplemental Information, RM2017-3

Integrated Financial Plan explains that the amounts of these obligations could change significantly:

> Both the FERS and CSRS amortization expenses projected in this plan [.9 for FERS and 1.7 for CSRS, the same numbers used for FY2017] are based on OPM's projections made using government–wide actuarial assumptions. OPM has recently indicated its intention to begin using postal-specific demographic assumptions (but not salary-increase assumptions, which may have a greater impact) with its 2018 actuarial valuation; however, ***sufficient information is not available to quantify the impact on the 2018 funding requirement***. We do not anticipate having this information until late in 2018.
>
> There is no estimate included in the [FY2018] plan for the non-cash portion of workers' compensation expense because it is highly sensitive to changes in discount (interest) rates. ***For example, an increase of 1 percent in interest rates would decrease the liability at September 30, 2017, and 2017 expense by approximately $1.9 billion***…. All of these costs are excluded from our controllable income (loss) calculation, as they are ***dependent on actuarial assumptions, interest rates, and other factors outside of management's control***. *Id.* at 3-4 (emphasis added).

So, under this caveat, if interest rates increase 0.5 to 1.0%,[21] workers compensation liability could decrease by one to two billion dollars.[22] There could also be a large difference between the prefunding or normal cost estimates and the final assessed amounts. For example, in 2017 the Postal Service estimated RHB normal costs[23] to be $2.8 billion, but OPM later assessed $3.3 billion of normal costs, a difference of $0.5 billion. Thus, factors beyond the

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(Aug. 10, 2017) at 1-2. Note that the 2018 IFP classifies $2.8 billion of the normal costs as controllable expenses and the remaining $0.5 billion as uncontrollable expenses. Further clarification by the Postal Service would be helpful.

[21] A recent article in the Wall St. Journal found "a half-percentage point rise this year in the 10-year U.S. Treasury note yield – a barometer that influences borrowing costs for governments, consumers and corporations …. The development has significant implications for financial markets." *The Wall St. Journal* (Feb. 21, 2018) at A1, at https://www.wsj.com/articles/investor-sentiment-proves-robust-as-u-s-yield-closes-in-on-3-1519122601?mod=searchresults&page=1&pos=2.

[22] Most recently, the USPS Preliminary Financial Information (Unaudited), January 2018, (Feb. 22, 2018) at 1, shows a Workers Compensation credit for January of $505 million.

[23] Beginning in 2017, the Postal Service was required to make an annual payment into the RHB Fund for "normal costs", the amount "equal to the value of the additional retiree health benefits earned by employees that year." For example, postal employees earned future retiree health benefits with a present value of $3.3 billion as a result of work performed in 2017. Schuyler, M., "A Primer on the Postal Service Retiree Health Benefits Fund," (Aug. 11, 2016), at https://taxfoundation.org/primer-postal-service-retiree-health-benefits-fund/.

control of the Postal Service and the Commission could affect the net profit figure by billions of dollars. While there is very little that can be done to minimize these uncertainties, the Commission can at least set up a process to respond to any hardship that may result.

Finally, the unstated assumption underlying the Commission's plan is that the Postal Service will pay the annual prefunding amounts assessed by OPM. But the Postal Service has defaulted on its RHB obligations every year since 2010, including as recently as September 2017 – apparently without additional interest or penalties. Its September 2017 default included not only its RHB obligations, but also its CSRS, FERS, and normal costs payments. Given this history of defaults, future defaults would not be surprising. In fact, in scoring H.R. 756 in June 2017, the Congressional Budget Office assumed that the Postal Service would continue to default on certain obligations.[24] The recently released President's Budget for 2019 also assumed continued defaults.[25] In light of these agencies' presumptions of future defaults, formalized in official documents, the Commission should be concerned that its plan will be undercut by future defaults.[26] In effect, the prefunding obligations would be used to justify higher rate increases, mailers would pay those amounts through new rate increases, but the Postal Service would not actually pay out the assessments. A mid-course review could address this problem if it occurs.

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[24] Congressional Budget Office Cost Estimate: H.R. 756, (June 1, 2017) at 13, at https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/hr756.pdf.

[25] President's Budget Request for 2019 (February 12, 2018) ("Given the Postal Service's history of using defaults to continue operations despite losses, the Budget reflects defaults on required pension and retiree health amortization and normal cost payments") at 1217, at https://www.whitehouse.gov/wp-content/uploads/2018/02/oia-fy2019.pdf.

[26] The availability of a default option also undercuts the Commission's efforts to impose fiscal discipline through the rate cap and incentivize improved performance. *See* Section IV, *infra*.

B. A Fair and Flexible Process Should Include a Mid-Course Review and an Opportunity for Mailers to Request a Special Review.

Mistakes based on inadequate data and uncertainties may result in inequities or unintended consequences. A process for a mid-course review and special proceedings would give the Commission flexibility to make adjustments in real time to prevent significant harm. While the exigency provision already allows the Postal Service recourse for “extraordinary and exceptional circumstances,” there is no similar safety valve for ratepayer relief.

While it is true that the PAEA includes the objectives of predictability and reducing administrative burden,[27] these must be weighed against the other objectives, such as just and reasonable rates, financial stability, and more efficient operations.[28] We believe that establishing a five-year plan already provides mailers a degree of predictability which is not materially diminished by allowing interim adjustments. The Commission could limit the issues raised in a special review, and the possibility of further adjustments would reduce the urgency in any particular proceeding to resolve all issues at once. While minimum due process protections must be afforded, the Commission could adopt expedited procedures for special reviews, similar to those applied in exigency cases. In the past, the Postal Service’s use of the exigency provision has not been seen as interfering with the objectives of predictability and administrative ease.[29]

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27 39 U.S.C. §§ 3622(b)(2) & (6).

28 *Id*. at §§ (8), (5), & (1).

29 *See* Order No. 4257 at 61, 65, 72 & 81.

1. The Commission should schedule a mid-course review.

The Commission should establish a proceeding to review the effectiveness of the new rate system after two years of data are available, i.e., in the 3rd year.[30] Scheduling a mid-course review now would send a signal to the industry that difficulties arising from the plan will be addressed before significant harm occurs. This could prevent many mailers from leaving the network. The mid-course review could be limited to specific issues, such as prefunding obligations, increased revenues from Competitive Products, and noncompliance, to prevent it from becoming a Cost of Service proceeding. Expedited procedures could apply.

2. The Commission should establish a safety valve mechanism to allow mailers to request a special review when unexpected changes result in significant harm.

In addition to scheduling mid-course review, the Commission should create a safety valve mechanism for mailers, similar to the Postal Service's current exigency provision.[31] Mailers face substantial rate increases for five years and should have a reciprocal mechanism to request review either under an exigency-like standard or when triggered by specific events.

An example of a parallel standard for mailers, based on the language of the Postal Service's exigency provision at 39 U.S.C. § 3622(d)(1)(E), is:

> Rates may be adjusted on an expedited basis due to either extraordinary or exceptional circumstances, provided that the Commission determines, after notice and opportunity for a public hearing and comment, and within 90 days

[30] The Commission has already scheduled a review upon completion of the five-year plan, noting, "It is critical under a price cap regime to be able to revisit a plan's performance quickly enough to prevent either persistent windfalls to the firm that harm consumers or persistent revenue shortfalls that damage the producer." Order No. 4258 at 37. But the five-year plan will have already played out by then, and the message to mailers today would be that the plan is written in stone. Moreover, we believe that five years is too long to wait for relief if unexpected changes occur in the first few years.

[31] We believe that this proposal creates symmetry in the opportunity to request adjustments to the rate plan. The Postal Service currently can file an exigency case under 39 U.S.C. § 3622(d)(1)(E), but mailers have no such safety valve. Our proposal would create a parallel safety valve process for mailers (which are the ones shouldering the burden of substantial rate increases), based either on a standard similar to the Postal Service's exigency standard or on certain triggering events. And the mid-course review would be scheduled without the need for either party to file a request.

after any request by any ratepayer of the Postal Service, that such adjustment is necessary to prevent unjust, unreasonable, or unlawful rates.

Alternatively, the Commission could specify that mailers can obtain limited review, upon request, if certain triggering events occur. Triggers for mailers could include:

- Congressional action that changes basic assumptions in the five-year plan to mailers' detriment.
- Defaults by the Postal Service on prefunding or related obligations over a specified threshold.
- Growth in Competitive Product profits over a certain threshold.
- A regulatory change that results in a Postal Service windfall (e.g., a re-calculation of prefunding obligations or a workers compensation adjustment which substantially reduces Postal Service expenses by more than a threshold amount).

Expedited procedures, such as those now used in exigency proceedings, may be applied in special reviews, and the issues raised may be limited in order to avoid re-litigating findings for which the underlying facts or assumptions have not changed.

III. TO PREVENT OVERLY INFLATED RATES AFTER FIVE YEARS, THE COMMISSION SHOULD CONVERT THE ADD-ON RATE INCREASES IN YEARS 4 AND 5 TO TEMPORARY SURCHARGES.

The Commission's goal in Order No. 4258 is to fix a current imbalance in the Postal Service's finances to put it on a path to stability. The Order proposes increases of 2 to 3% (in addition to CPI) over five years to remedy this temporary financial situation. It calculates that these rate increases are roughly equivalent to a 5.8% one-time increase, and will cover an imbalance of $2.7 billion annually. By setting an end point after five years for the 2 - 3% add-on[32] increases, the Commission has implicitly recognized that once the current financial problem is remedied, the add-on rate increases should be discontinued.

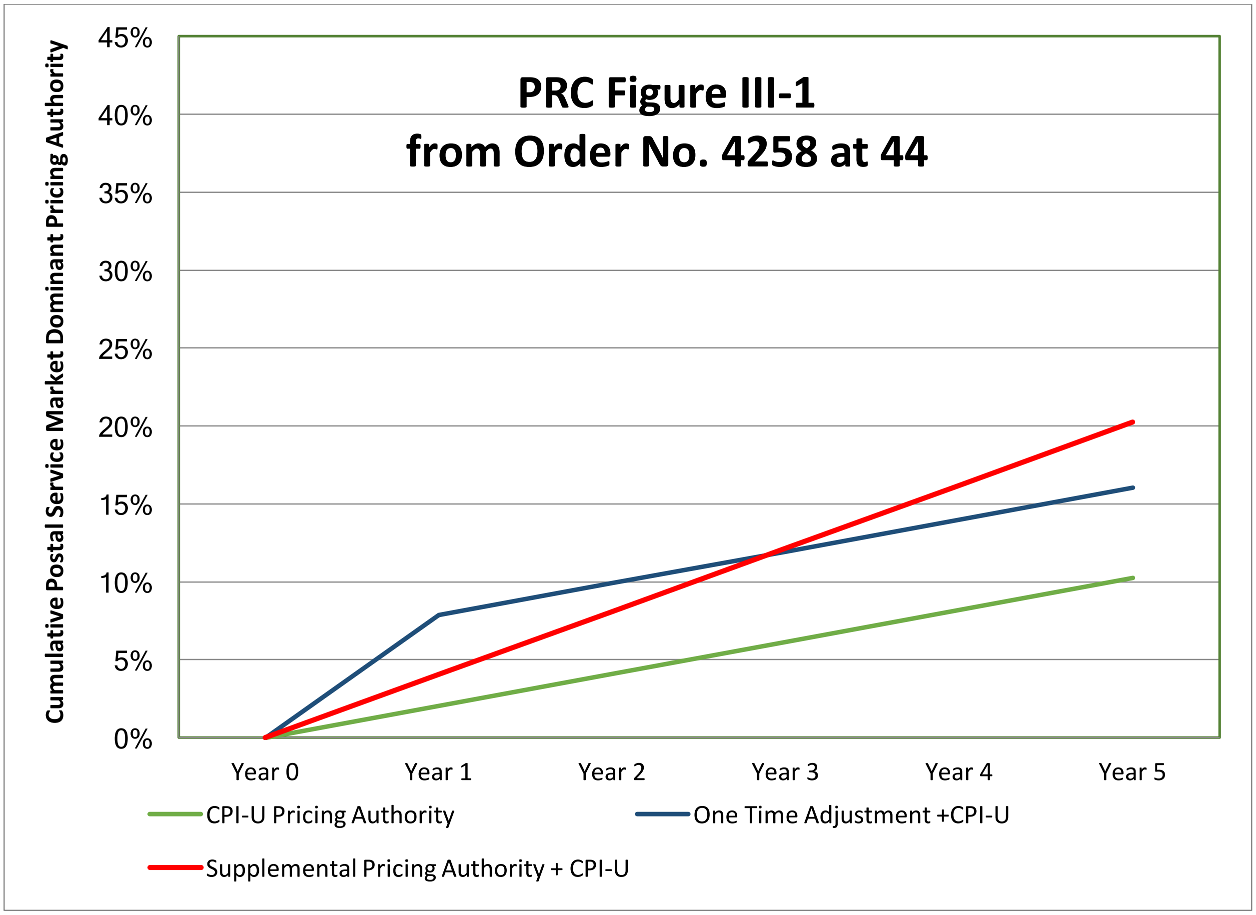
[32] We refer to the portion of the annual increase due to the 2% (or 3%, if the PIM is applied) as the "add-on" rate increases. This term excludes the CPI portion of the annual rate increase, which is a permanent rate increase.

But the Commission's plan suffers from a major flaw that will impose an unfair burden on ratepayers in Year 6 and every year thereafter: While five years of extra-2% annual increases is indeed required to provide the same amount of revenue as a one-time 5.8% increase for five years (i.e., an average of $2.7 billion per year), only three years of increases are needed for the *rates* to reach the same *level* that a one-time 5.8% increase would reach. If the rates continue to grow in Years 4 and 5, then by Year 6 the increases will be almost twice as high as needed to remedy the $2.7 billion problem. And if CPI is applied to that high base in Year 6 and subsequent years, the resulting revenues will be vastly larger than needed. Realization of the 1% PIM would add on to these levels. We demonstrate in the graphs that follow that accepting the Year 5 rates as a base and applying only-CPI increases thereafter results in revenues far beyond what is needed.

There is a relatively simply way to fix this: Convert the add-on rate increases in Years 4 and 5 to temporary surcharges to be removed at the end of Year 5. This would reduce the base to which the Year 6 CPI increase is applied. The temporary surcharges would be separately tracked and accounted, as was done for the exigency surcharges in 2013 - 2015.

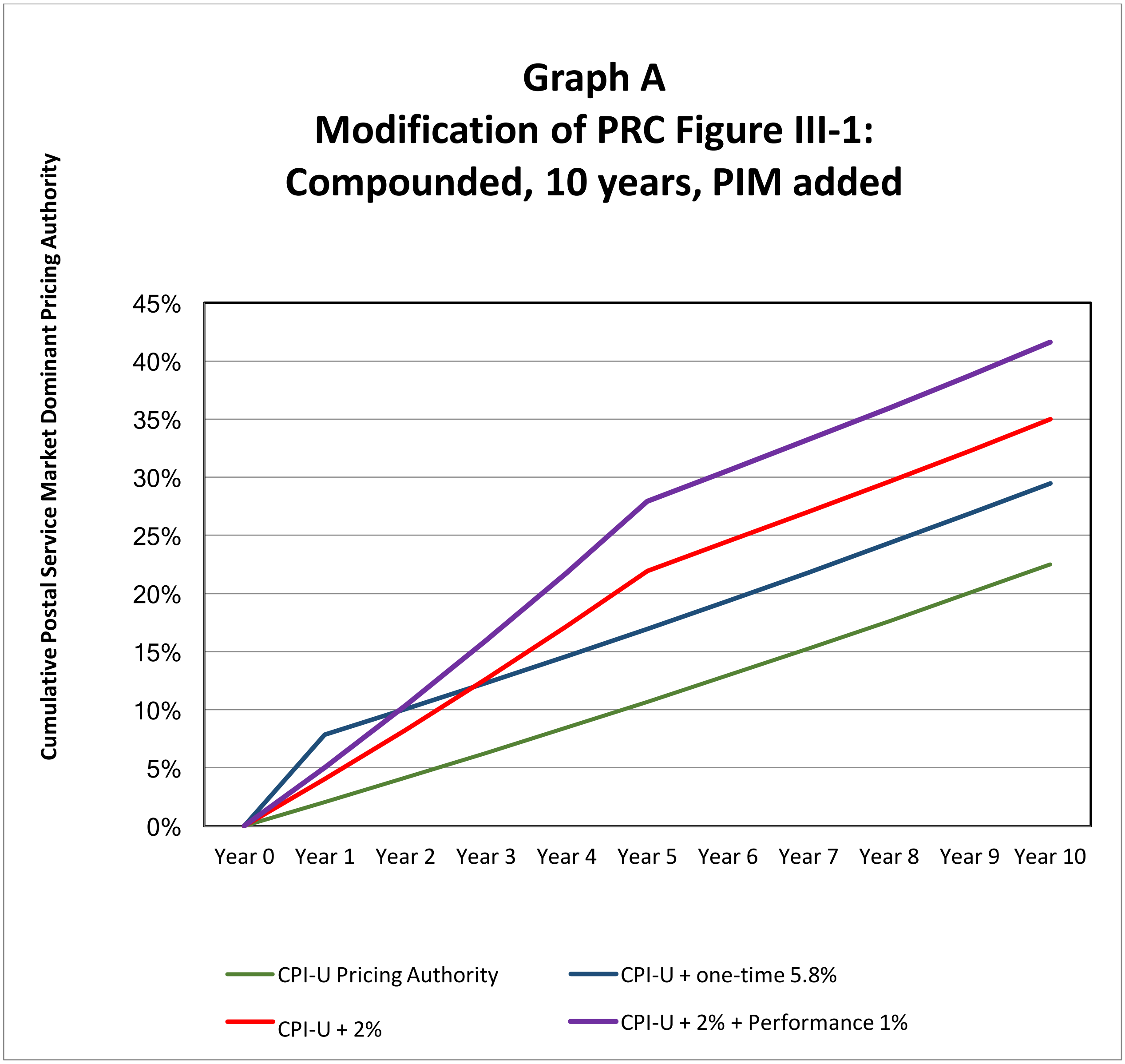
Analysis of the Commission's own graph supports this proposed modification. Order No. 4258 presents a graph of the rate increases in Figure III-1,[33] reproduced below:

[33] Order No. 4258 at 44.



The PRC's Figure III-1 does not compound the rate increases, does not go beyond five years, and does not include the 1% PIM.[34] If the rate increases are compounded, the graph is extended to ten years (with CPI only beyond Year 5), and a curve is added to show the PIM, Graph A is obtained:

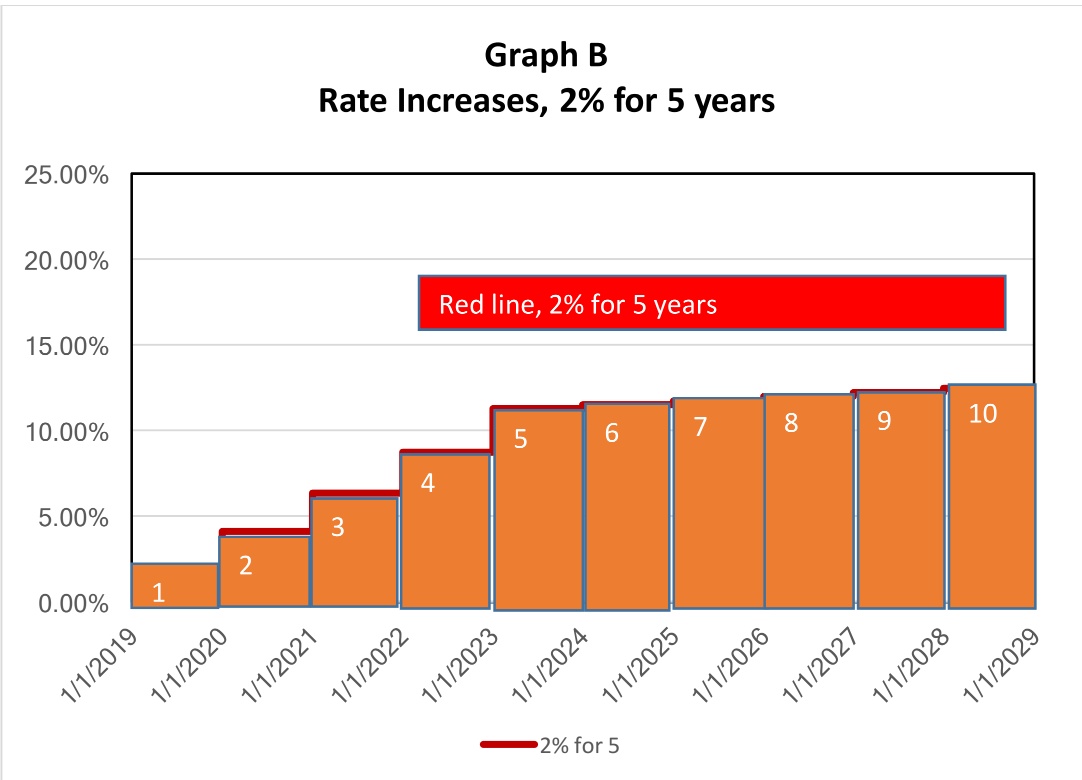
[34] All of the graphs reflect the Commission's approach of assuming constant CPI and developing "estimates of future revenues … by applying the future rate increases to current mail volumes." *Id*. at 42.



Graph A shows that at the beginning of Year 10, rates with the one-time 5.8% increase would be 29.5 percent higher than the current base; rates with the five-year 2% add-on would be 35.0 percent higher; and rates with the 2% add-on + 1% PIM would be 41.6 percent higher.[35] All of these include continued CPI increases.

[35] The increases would be even higher for Periodicals and Marketing Mail Flats.

To analyze the increases, we converted Graph A into a step graph, which allows the area under the curves to be proper measures of additional revenue.[36] We also removed the CPI portion of the increases so that the curves show only the additional revenue that is due to the add-on rate increases, relative to the revenue in the base period. For example, Graph B shows the curve for the add-on 2% increase for five years, and no add-on thereafter.[37] (The vertical scale is reduced, to account for the removal of the CPI effects.)



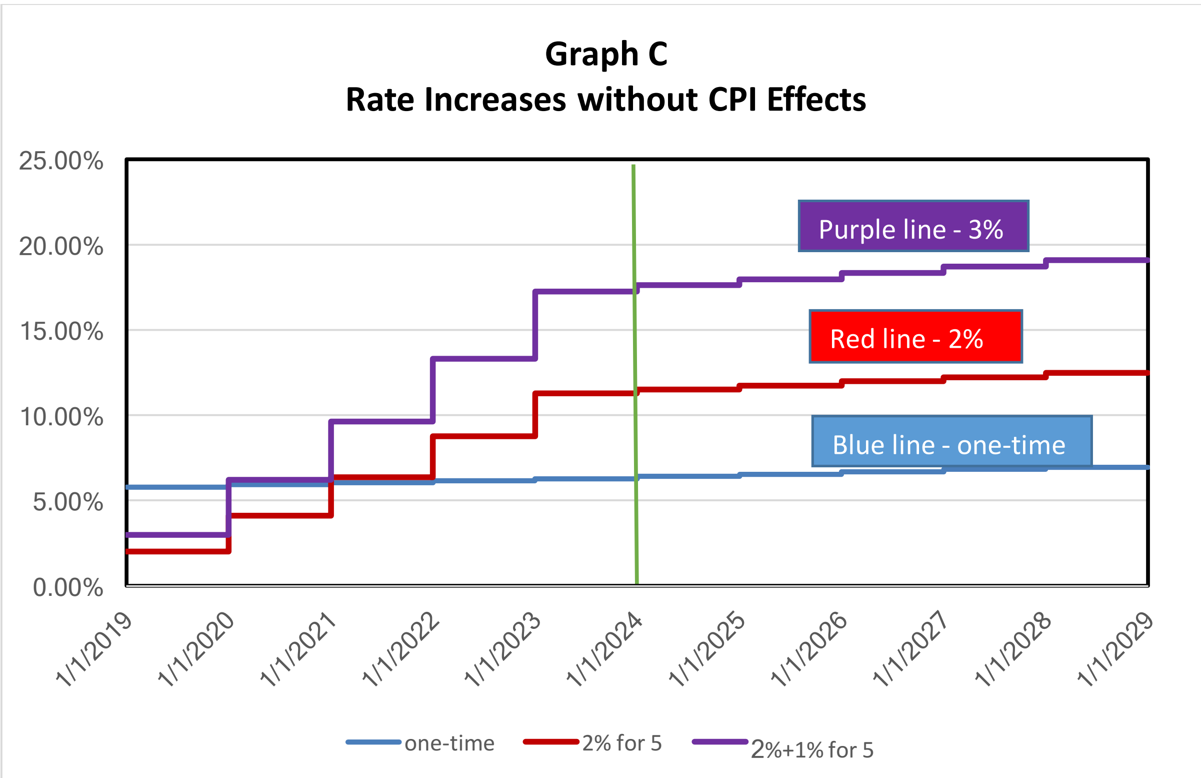
The vertical rectangle under each year in Graph B is the additional revenues for that year due to the 2% proposal, relative to the base. For example, rectangle 3 is the additional revenue for Year 3. The area under the "2% for 5 years" curve for 10 years is the sum of

[36] We relied upon the data in Library Reference PRC-LR-RM2017-3-2xlsx, RM2017-3 (Dec 1, 2017).

[37] Note that in Graphs B through D, the curves are not perfectly flat after five years due to compounding from the CPI increase.

rectangles 1 through 10 and represents the additional revenue due to the 2% increase (not including CPI) for the first ten years, with the extra 2% discontinued after Year 5.

Graph C shows the rate-increase lines for the three options: (a) the one-time 5.8% option (blue line), (b) the 2% for five years option (red line), and (c) the 2% plus the 1% PIM for five years option (purple line). The vertical green line marks the end of 5 years.



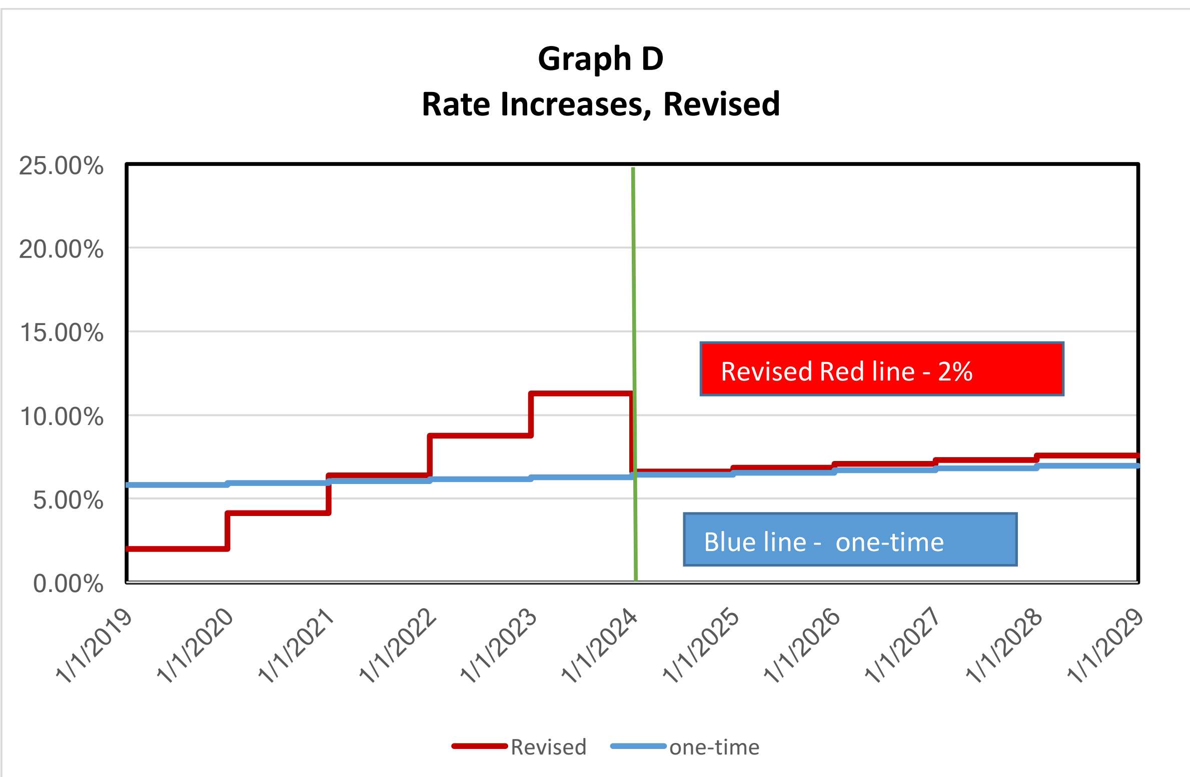
These curves may be referred to by their colors. The areas under them are proper measures of additional revenue, relative to base revenue, as explained above.

The revenue under the blue line is what is needed to achieve an additional $2.7 billion per year. The Commission explained that, taking into account present value, the area under the red line up through Year 5 (ending at the vertical green line) is roughly the same as the corresponding area under the blue line.[38] This much is true, but the Commission's analysis

[38] *Id*. at 43.

ended at Year 5. The problem is that if the red line is not reduced after Year 5, even if the 2% add-on increases end, then the area under the red line will be significantly larger than the area under the blue line. Similarly, the area under the purple (3%) line will be substantially larger than the area under either the blue or red lines. Our graphs end at ten years, but this effect would continue.

The solution is to bring the red-line rates down to the blue-line level after Year 5 by converting the add-on increases for Years 4 and 5 to temporary surcharges. If the Year 4 and Year 5 surcharges are removed after five years, then the area under the revised red line will equal the area under the blue line. This is depicted by the "Revised Red Line" in Graph D. With this modification, the Commission's plan will provide, on average, the additional $2.7 billion per year deemed necessary. But without this modification, CPI will be applied to the higher rates at the end of Year 5, resulting in much more revenue than needed in later years.



Temporary surcharges are preferable to permanent rate increases for policy reasons too. While mailers tend to understand the need for annual CPI increases to cover inflation on input prices and do not expect CPI increases to be removed, the prospect of paying extra after a financial problem has been remedied may have the effect of discouraging long-term plans to stay in the mail.[39] In this case, there is a great perceived difference between five years of fixed increases with inflated rates thereafter versus three years of permanent increases, two years of surcharges, and the possibility of interim adjustments. As demonstrated in mailers' restrained demand response to the temporary exigency surcharges from 2013 to 2015, a more flexible approach with surcharges and adjustments may encourage mailers to stick it out and stay on the network.

III. THE COMMISSION SHOULD REMOVE THE PERFORMANCE INCENTIVE MECHANISM BECAUSE IT IS BASED ON FLAWED REASONING AND WILL NOT WORK IN PRACTICE.

Under accepted economic theory, a firm subject to cost of service regulation has little incentive to keep costs down or to improve efficiency since it is allowed to set rates to recover all of its costs (and, for most utilities, a fixed rate of return).[40] Price cap regulation unlinks costs and prices. If the firm is to earn profits, it must work to keep its costs below revenues, which are constrained by the cap. It can also work to increase volume. Greater efficiency will lower costs, resulting in greater profits. Thus, if the cap is set properly, the cap system acts as a powerful incentive for efficient operations.

Prior to 2006, the PRA's cost-of-service approach allowed the Postal Service to cover increased costs by increasing rates, consistent with breakeven. It required the Postal Service to

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[39] Even if current elasticities fairly represent responses to routine rate adjustments, which is questionable, they do not represent tipping points, and they do not model mailer discouragement at the long-term character of a rate adjustment scheme that appears to impose extra burdens that last forever.

[40] *See* Kwoka at 5.

disgorge profits earned in one year by reducing rates or limiting rate increases in following years. In the PAEA, Congress implemented a cap system to limit rate increases while allowing the Postal Service to keep any profits (i.e., it allowed “retained earnings”). Congress used the cap mechanism to place pressure on the Postal Service to do everything possible to restrain costs, encourage volume, and improve operational efficiency. Congress contemplated that a cap set at the proper level, combined with allowing retained earnings, could provide postal management appropriate incentive to improve efficiency, hopefully resulting in net earnings. These earnings could then be used for investment or debt repayment, or for a rainy day. Congress also included an exigency provision as a safety valve for extraordinary or exceptional circumstances.

When Congress established the cap system, it set the cap at the CPI-U (“CPI”). Congress could have used a different index,[41] or it could have adjusted the CPI with an X factor (i.e., a productivity offset), making the cap CPI - X.[42] But Congress decided that the CPI, without any X factor adjustment, would provide the right level of restraint, set appropriate efficiency incentives, and result in acceptable rates. And, as noted, any profits resulting from increased efficiencies would redound to the benefit of the Postal Service in the form of retained earnings, not directly to mailers in the form of a reduced revenue requirement in a subsequent rate case.

Ten years later, the Commission has found that the Postal Service was unable to achieve “medium- and long-term financial stability” under the CPI cap.[43] Specifically, it has

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[41] Economic theory requires that the index used in a cap system be exogenous to the regulated entity so that the system does not devolve into a breakeven system. In the years prior to the PAEA, annual rate increases under the PRA were on average close to CPI.

[42] *See* Kwoka at 8 & 11-12; Comments of the Public Representative, RM2017-3 (Mar. 20, 2017) at 49.

[43] *See* Order No. 4257 at 4.

determined that an additional $2.7 billion of annual revenue is needed. To achieve this, it has proposed to retain the cap system but add to the CPI an X factor of +2 percentage points for five years. A CPI + 2% cap is deemed to provide a proper level of restraint, which, assuming suitable Postal Service effort, will put it on a path to financial stability. But the Commission goes further, adding a potential 1% Performance Incentive Mechanism (PIM) to the revised cap.[44] As explained above, this additional, after-the-fact reward is not consistent with the underlying economic theory for a price cap system: If, as the Commission has concluded, the CPI + 2% cap provides the proper level of restraint while encouraging efficiency and making financial stability achievable, then why should the Postal Service's achievement of these goals trigger a relaxation of that constraint? The PIM is at best an unnecessary complexity, and at worst an economic distortion that will interfere with the proper functioning of the cap, which already has efficiency incentives built in. The PIM is also unworkable in practice. We examine these practical issues with respect to each component of the PIM.

A. The PIM's Efficiency Mechanism Component

In the proposed Efficiency Mechanism, the Postal Service receives an extra 0.75 percentage points of rate authority for each mail class if the running five-year average of the annual percentage changes in Total Factor Productivity (TFP) for the overall Postal Service is at or above a 0.606 threshold.

First, the shortcomings of the TFP as a reliable measure of efficiency have been described by the Public Representative and the Postal Service, as recognized by the

[44] As discussed *infra*, the PIM would give the Postal Service one additional percentage point of cap authority if it achieves certain efficiency measures based on the TFP and does not reduce service standards. This 1% increase would be permanent and would not be removed even if the Postal Service fails to meet the conditions in future years. Specifically, 0.75 percentage points are given if the 5-year average increase in the Total Factor Productivity (TFP) is at least 0.606, and 0.25 percentage points are given for a class if no aspects of the service standards for that class are reduced. *See* Order No. 4258 at 62, 64, and 73.

Commission.[45] At best, the TFP is a long-term measure; because it does not measure efficiency changes in a given year, a five-year average was proposed.[46] But as a result of using a five-year average, the TFP has become particularly impractical in this application. The TFP for FY 2017, released after Order No. 4258, shows a *decrease* of 0.561%. The five-year average is now at 0.307%, substantially lower than last year's average of 0.614%. The average of 0.307% includes increases for 2013 to 2015, respectively, of 1.8% (an unusually high figure), 0.3%, and 0.1%. FY 2016 shows a *decrease* of 0.2%. The five-year average for FY 2018 will no longer include the 2013 increase of 1.8%, so it will probably be even lower than the five-year average in FY2017. The conclusion is that it is unlikely that the 0.75% Efficiency Mechanism will be attainable in the first two to three years of the Commission's proposed plan.[47]

Second, as a practical matter, the TFP is likely to decline after investments are made. This is because: (a) it takes time for the Postal Service to tighten operations around new investments and make them work, (b) even with straight-line depreciation, the measure for capital used, which appears in the TFP's denominator, could be a bump-up that causes the ratio to decline, and (c) part of the existing performance may be due to equipment that has already been depreciated, providing a low denominator (capital used) as a starting point. It becomes clear that the TFP is not a suitable measure.[48] The fact that no better measure exists does not

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45 *See* Order No. 4258 at 59-60.

46 *Id*. at 62.

47 Lowering the 0.606 threshold, which is based on the average TFP level as of 2016, would reduce what the Commission has already considered an acceptable level of performance. Lowering the bar to accommodate failure undercuts the effectiveness of the mechanism as an incentive to improve efficiency.

48 Another difficulty with the TFP is that the it fails to effectively deal with qualitative changes in the principal output, which is the numerator. *See* Declaration of Bzhilyanskaya, RM2017-3 (Mar. 20, 2017) at 1; Order No. 4258 at 60. For example, it is difficult to measure the change in postal output when mail pieces receive more rapid service, when security is increased, when a new service like Informed Delivery service is offered, or when steps are taken to treat employees more fairly. Evidence of this was provided recently by the Postal Service in a CHIR response, which refers to "improve[d] service," "cybersecurity," "digital investments," and "retail improvements." Responses of the United States Postal Service to Questions 1-6 of Chairman's Information Request, PRC Docket No. ACR2017 (Feb. 23, 2018) at Question 6. The emphasis on TFP in the Efficiency Mechanism could give the Postal Service an incentive not to make these kinds of qualitative changes.

justify using it. *Id*. at 63. And it could be quite discouraging to the Postal Service – and even a disincentive – to watch efficiency decline as it makes investments.

Finally, an increase in the TFP measure in one year would result in a permanent rate increase and lead to a stream of additional revenue that would go on forever, even when subsequent TFP measures become stagnant or decline.

B. <u>The PIM's Service Mechanism Component</u>

The Service Mechanism part of the PIM gives an additional 0.25 percentage point of rate authority to a class of mail if the service standards for that class are not reduced during the year. It too has major flaws:

First, this mechanism deals only with service ***standards***, not actual ***performance***. The Commission states that "[t]his service quality-based rate authority is linked to the *service standards and the business rules* rather than *actual service performance* such as on-time delivery performance." It then indicates that actual service performance is "most appropriately dealt with in the ACD."[49] The Postal Service can realize the 0.25% reward simply by doing nothing – it need not take any action to improve actual performance. In fact, if it realizes that its actual performance will not meet existing service standards, it can decide to remain noncompliant; by not reducing the standards to reflect reality, it will "earn" the 0.25% award. This makes the 0.25% a give-away-with-certainty instead of an incentive.

Second, such a focus on a service standards is out of line with service quality regulation in other industries. Usually, the regulator is concerned that the regulated firm will reduce service levels as a means of making a profit when placed under the constraint of a price cap.

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[49] *Id*. at 71-72 (emphasis added).

To counter this, the regulator may decrease the cap if service levels slip.[50] But the Service Mechanism offers an *increase,* instead of a *decrease*, for simply *maintaining* a standard, and, as noted, it focuses on the published service standard instead of actual performance.

Third, rewarding the Postal Service for not changing service standards may be counter-productive to effective operations. Changes in standards, based on costs, needs, and changed circumstances, should be an ordinary part of operating a postal system. There may be, for example, a consensus that a reduction in one or more elements of the standard, (e.g., relaxing two-day service to an area with inadequate transportation) is preferable to an increase in rates. But the Postal Service might be reluctant to change the service standard if it results in loss of cap authority. Or the Postal Service might consider increasing some service standards and reducing others in a class. This would destroy eligibility for the award since apparently *all* aspects of standards for a class must be maintained at the same levels. The service mechanism would then be giving the wrong incentives to the Postal Service and hindering meritorious changes.

Finally, as with the Efficiency Mechanism, award of the 0.25% for not changing service standards would be a permanent rate increase and generate additional revenue to be compounded each year in perpetuity, even if actual performance plummeted in future years. It is difficult to see how this kind of reward can be justified.

In view of these considerations, neither component of the PIM should be implemented. The Commission's proposed rate cap provides adequate incentive to improve performance, and the PIM will simply introduce extraneous signals that interfere with the proper functioning of the cap system.

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50 Kwoka at 9.

IV. CONCLUSION

Order No. 4258 proposes a new rate system that will affect all aspects of the postal industry for five years and beyond. It is inevitable then that various features of the plan will be hotly debated by stakeholders with conflicting interests. The proposal may be vulnerable to the extent that it rests on inadequate or disputed facts, unreliable measures, and uncertainties arising from conditions that could change dramatically. But the Commission could address these shortcomings, in large part, by instituting a process that allows for interim adjustments to correct mistakes and to respond to changed circumstances. We propose that the Commission schedule a mid-course review and adopt a process for mailers to request a special review, similar to the Postal Service's exigency procedure.

We also propose (a) converting the 2 - 3% add-on rate increases in Years 4 and 5 to temporary surcharges to prevent unjustifiably high rates after Year 5, and (b) removing the 1% PIM because it is an unworkable, ineffective incentive, and the Postal Service will probably not be eligible for the efficiency reward for at least two years anyway. If circumstances change in the next two years, the Postal Service could raise these issues at a mid-course review. But modifying the plan now sends a signal to mailers that the Commission will be flexible and sensitive to their needs. This would encourage mailers to remain on the network in the early years of the plan.

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